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Commentary on Pertinent Economic Issues

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The Rules Of The Game

One of the things that fascinates me about economics is that it is a constantly-changing discipline. The rules that govern economic behavior don't always work the same way. For example, there are times when people will step up their buying when they see prices beginning to rise more rapidly than before, while there are other occasions when consumers will hold back, hoping for prices to fall. Businessmen are no different. Sometimes they will spend more, even though their sales and profits are falling, while other times they will trim their outlays in the same setting. The challenge to economists, of course, is to figure out beforehand whether the rules are working—and in which way.

One Singular Sensation

One thing economists could depend on, however, was economic policy. As sure as the sun rises in the east and sets in the west, monetary and fiscal policy could be counted on to tighten up when the economy got overheated, and loosen when business was slipping. Tighter money, of course, would mean a reduced availability of money and credit and higher interest rates. On the fiscal side, tightness would involve some combination of tax increases and spending cuts. An easier monetary policy would see the Federal Reserve expanding the supply of money and credit, in the process lowering interest rates, while a more relaxed fiscal policy, of course, meant more spending and/or tax cuts.

What is more, these policies could be relied on to operate in tandem. In other words—when tightness was called for, both monetary and fiscal policy would tighten; the opposite would occur when the economy needed a lift. The results of these changes in economic policy were comparatively easy to predict: Less money at a higher cost, combined with reduced spendable incomes, invariably caused consumers and businessmen to retrench, thereby slowing economic activity and cooling off inflation. More money in circulation, lower interest rates, and increased incomes due to more spending by Washington and/or lower taxes would lead to more spending, hence a pickup from whatever softness might have existed.

Gradually over the postwar years, the workings of economic policy began to change. More and more of the burden of managing the economy was placed on the shoulders of the Federal Reserve, since fiscal policy became less and less flexible. This was because fiscal policy became increasingly politicized as elected officials got in the habit of promising the electorate more than there were revenues to pay. Deficits in Washington's budget became the rule, rather than the exception, as was the case in the prewar era. In the past 30 years, there have been only two in which Washington's budget was *not* in deficit, the last one being 1969!

This two-decade string of deficits alone did not render fiscal policy inoperative. It is theoretically possible for the economy to be just as restrained from a sharp reduction in a budget deficit as from an actual surplus; it depends on how much government spending is cut and/or revenues raised. The problem is—even a shrinkage in the deficit has been hard to come by. Indeed, after averaging $2 billion, or 0.4 percent of GNP in the 1950s, Washington's budget deficit rose to $6 billion, 0.8 percent of GNP in the 1960s, $35 billion, 2.1 percent of GNP in the 1970s—and $157 billion, 4.1 percent of GNP in the 1980s.

Policy Split Caused Some Surprises

With policy becoming more and more one-sided, it was little wonder that many economists' analyses and forecasts came a cropper. For example, many thought the huge budget deficit that developed in 1982 in the wake of the Economic Recovery Tax Act of 1981 would stimulate the economy. Indeed, that was its purpose: To push the economy fast enough so that the resulting increase in government tax revenues would be sufficient to balance Washington's budget within a few years, without the need to make major spending cuts. This was not an unreasonable assumption, since traditional analysis first offered by John Maynard Keynes suggested that Federal deficits stimulate the economy by adding to aggregate demand.

But here was the first major instance where fiscal policy did not work in tandem with monetary policy. The Federal Reserve was actively fighting inflation in this period. It did so by restricting money growth: In the first half of 1982 the money supply was flat, and by the middle of

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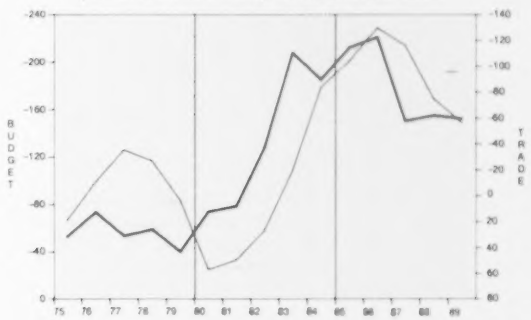
that year was only about six percent higher than it was 15 months earlier. On the other hand, budget deficits must be financed, and bigger budget deficits require more Federal borrowing. Washington always gets first claim on the nation's financial resources. So, with the backdrop of reduced credit availability and a low domestic savings rate, Washington's greater financings resulted in less funds left for the private sector—business and consumers—along with comparatively high interest rates. In retrospect, it is not too difficult to see why the economy in 1982 was not only not stimulated by the burgeoning budget deficit—it was actually held back by it.

CHART I
REPORTED FEDERAL BUDGET DEFICIT (THICK) VS
REAL NET EXPORTS, NIA BASIS (THIN)
(BILLIONS OF DOLLARS) <INVERTED SCALES>



Sources: Treasury Department; Commerce Department

In this "test of wills" between tighter money and an easier fiscal policy, monetary policy won. The result was one of the longest and deepest recessions of the postwar era, which came to an end only after the Federal Reserve eased its grip and allowed more money and credit to flow into the economy, thus lowering interest rates to the point where private sector borrowing could resume. Unfortunately, the economic recovery did little to narrow the now 12-digit budget deficit. As a consequence, other side effects began to appear.

Deficit Aftershocks Rattle Goods Producers

For one thing, Washington's borrowing needs continued to escalate. This was necessary to finance not only each year's deficit, but to refinance previous deficits, as well as numerous off-budget activities, sponsored enterprises and loan guarantees. This had the effect of keeping interest rates relatively high, especially when adjusted for inflation. In turn, this inhibited those industries that rely on the availability of low-cost credit such as construction, household furnishings, and automobiles. The number of residential dwelling units constructed in 1985, for example, was 26 percent fewer than it was 13 years earlier—notwithstanding a 52 percent jump in the age group that buys the most homes, the 25-34 year olds. As for autos, Detroit sold 15 percent fewer cars in 1985 than it did a dozen years earlier.

But that's not all. Washington's budget deficits soon began crowding out the entire goods producing sector of the U.S. economy. It did this—not by pulling money away directly, but by creating conditions such that goods producers didn't need to borrow the funds. Of course, I am referring to another big deficit that developed—the one in our foreign trade (Chart I). It arose because the dollar nearly doubled in value between July 1980 and February 1985, as foreign investors sold their currencies and bought dollars in order to partake of our high interest rates. Needless to say, U.S. exporters saw their sales slump, while those domestic businessmen who competed with goods produced abroad found their market share diminishing as well.

Meanwhile, back home, the Government's interest expense began rising rapidly, the result of years of accumulated deficits. This should not have been surprising, even though the budget deficit had been shrinking relative to the GNP since 1983. Washington's debt outstanding tripled during the 1980s, and now stands at 55 percent of GNP—the highest in nearly 30 years (Chart II). The average interest rate that Washington must pay to service this debt is now 8.9 percent, compared with three percent in 1961, when the government's debt last was this size relative to the economy, and less than one percent in 1946, when the debt was over 25 percent larger than the GNP.

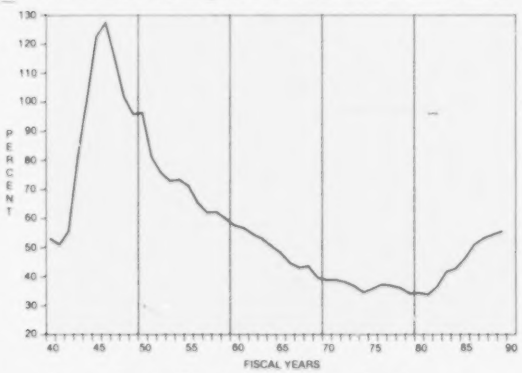
Several years ago, Washington's annual interest expense exceeded *all* outlays for such programs as grants to state and local governments, foreign aid, housing assistance, student financial aid, veterans' medical care, plus the cost of government-sponsored research. In 1988, these interest outlays about equalled Washington's *total* budget deficit. This year they could exceed it by at least $20 billion, as the share of Federal

spending that must be devoted to servicing Washington's debt has become the largest in history.

The True Burden Is Spending

All this talk of the budget deficit might lead the reader to think that this is the only way one measures the burden of running the government. Not so. The true burden of government is measured by how much it spends, not by how these expenditures are financed. For Washington does not have money of its own to spend; it must tap one or both of two sources—taxing and borrowing—to obtain the funds it needs. As you can imagine, both involve the private sector giving up purchasing power to the public sector.

CHART II
TOTAL FEDERAL DEBT OUTSTANDING AS A PERCENT OF GNP



Sources: Treasury Department; Commerce Department

Taxing, of course, does it directly. And it seems logical to ask us to pay for the programs we receive from the government. The problem is—many people seem to think that government money, particularly Federal government money, comes from some mysterious, inexhaustible source, or at the very least, from "the other person." And woe to the politician who is this forthright and suggests raising taxes to pay for increased government spending—as Walter Mondale found out back in 1984.

Borrowing, on the other hand, is more nebulous. As such, it has become the preferred route, witness the spate of budget deficits referred to above. However, besides involving interest costs, borrowing also removes buying power from the private sector as people give up what might otherwise be spendable funds to buy Washington's Treasury bills, notes and bonds. If Washington borrows from abroad, it means not only high interest rates, but a strong dollar as well, with its attendant consequences on trade and our domestic production. And if the government was to borrow from the Federal Reserve, it would lead to the creation of new money, thus the potential for inflation. And inflation, of course, robs *everyone's* dollars of their purchasing power.

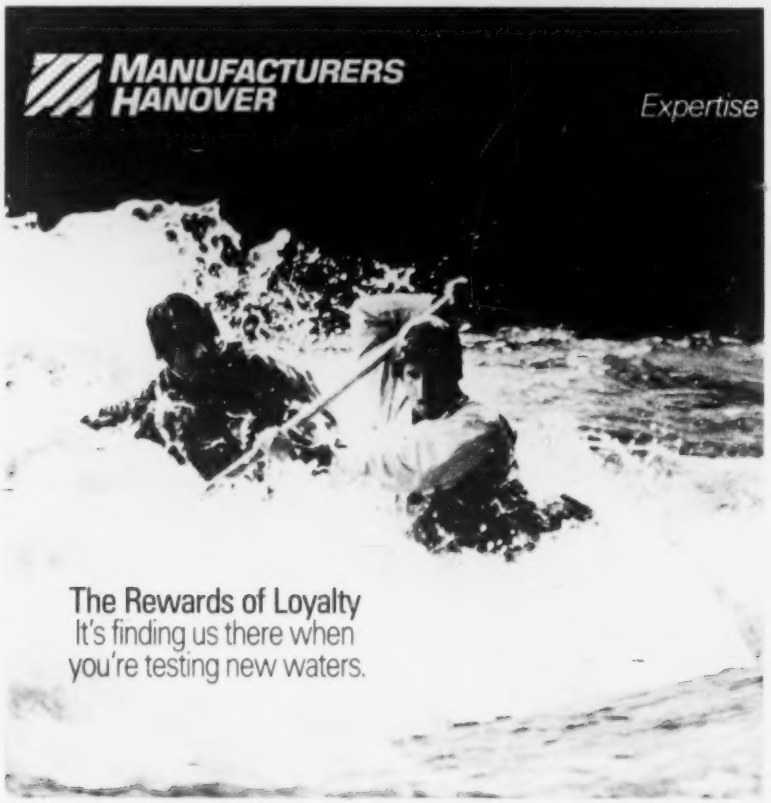
It is to their credit that, in this Congressional election year, the President and leaders of Congress are seriously examining ways to reduce Washington's budget gap—even if it involves raising taxes. Undoubtedly the arguments that this Report and others have been making over the years regarding the visible and less visible effects of the deficit have finally sunk in. While the U.S. economy as a whole is not in a recession, the goods producing sector certainly is, witness the flattening in output, and losses in jobs over the past year and more.

Déjà Vu All Over Again

The old rules of the game would have called for an easing of both fiscal and monetary policy to stimulate business activity. Right now, however, we have the same combination of economic policies we had in 1982: A loose fiscal policy accompanied by a tight money policy. As observed above, we saw eight years ago that big budget deficits and tight money do not mix. The right mix for that era—and this one as well—is for fiscal policy to tighten so that monetary policy can ease.

This prescription should produce lower interest rates. In turn, this would alleviate a variety of ills, ranging from the cost of servicing Washington's debt, to the cost of financing a car or a home. The dollar might even fall as foreigners find rates abroad more attractive than in the U.S., and this, of course, would help our exports while slowing imports.

Once monetary and fiscal policy are in better balance, the economy will be, too. The rules of economic behavior may still change from time to time—but the economy as a whole might well become more manageable—if not more predictable.



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